Office of Chief Counsel
Internal Revenue Service
memorandum
CC:[redacted]:TL-N-6645-99
[redacted]

date: May 23, 2001

to: [redacted] TEAM COORDINATOR, LMSB, NATURAL RESOURCES, [redacted]

from: ASSOCIATE AREA COUNSEL (LMSB)
[redacted]

subject: **NOPA Issues #43, 44, 45, and 46--[redacted]**
Audit Cycle [redacted]
TIN: [redacted]

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I. SUMMARY OF FACTS

[redacted] and Subsidiaries (the "Taxpayer") is an integrated oil and gas company filing a consolidated return on behalf of an affiliated group of domestic subsidiaries, including [redacted] ("[redacted]"). In [redacted] [redacted] formed [redacted] ("[redacted]"), a wholly owned Canadian subsidiary, to own and operate working interests in oil and gas in the [redacted] area of [redacted] Canada. Certain working interests in the [redacted] area were also owned by [redacted] ("[redacted]"), an unrelated oil and gas company. By [redacted], the oil reserves in the [redacted] area had been substantially depleted, but the gas reserves located at shallower depths remained largely undeveloped.

In early [redacted], [redacted] offered to purchase all the stock of [redacted] (the "[redacted] Stock") for $[redacted][1] [redacted]. The Taxpayer reported that $[redacted] of this price was allocated to [redacted]'s [redacted] gas reserves and associated assets (the "[redacted]"). According to the Taxpayer, the parties disagreed about the value of the [redacted]. Ultimately, the parties agreed to substitute certain of [redacted]'s like-kind properties (the "[redacted] Assets") with an agreed value of $[redacted] for the [redacted] Gas Assets and to form an equal joint venture between [redacted] and [redacted] with respect to the [redacted] Gas Assets and [redacted]'s [redacted] gas reserves and associated assets (the "[redacted] Assets"). On [redacted] to hold its interest in the new venture, [redacted] formed [redacted] ("[redacted]"), a wholly owned Canadian subsidiary.

On [redacted], the following transactions occurred: (1) [redacted] and [redacted] exchanged the [redacted] Assets and the [redacted] (the "Asset Exchange"); (2) [redacted] sold the [redacted] Stock to [redacted] for $[redacted] (the "Stock Sale"); and (3) [redacted], [redacted] and [redacted] entered into a joint operating and expense sharing agreement (the "JOA") under Canadian law with respect to the [redacted] and the [redacted] Assets (the "[redacted]"). On [redacted], [redacted] assigned its interest in the [redacted] to [redacted] (the "Contribution"). Pursuant to the JOA, [redacted] and [redacted] contributed the [redacted] Assets and [redacted], respectively (collectively, the "Venture Assets"), to the [redacted] in exchange for equal interests therein. [redacted], along with [redacted], also dedicated to the [redacted] the use of certain gas processing facilities, equipment, and existing oil well bores, although [redacted] reserved all [redacted] oil and solution gas rights, allowing it to continue to produce oil at its sole cost and for its sole benefit. The two known gas zones in the [redacted] area could be accessed only by re-completing existing oil wells after the oil zone was depleted. Pursuant to the JOA, all gas production by the [redacted] was shared in kind in accordance with the parties' [redacted] percent participating interests. For U.S. federal income tax purposes, the parties elected out of Subchapter K under section 761(a).[2]

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[1] All dollar amounts represent Canadian currency in approximate figures intended for illustration only.

[2] Except as otherwise indicated, all section references are

The [redacted] was managed by a committee consisting of two employees of [redacted] and two of [redacted], which reviewed production on a quarterly basis. According to the JOA, the day-to-day management was assigned to a project manager who would be an employee loaned by [redacted] or [redacted]. [redacted], an employee of [redacted], was designated the first project manager. Initially, the only other employees of the [redacted] were a production engineer, a reservoir engineer, and an engineering technician, all of whom were loaned employees from [redacted] or [redacted]. The JOA provided that the primary employer would pay the salaries of the loaned employees performing services for the [redacted].

Initially, the terms of the JOA prohibited a sale or assignment of an interest in the [redacted] to an unrelated party. Nevertheless, on [redacted], the parties mutually agreed to sell their interests in the [redacted] to [redacted] ("[redacted]") for cash, [redacted] receiving for its part $[redacted] (the "Cash Sale"). Out of the proceeds of the Cash Sale, [redacted] loaned [redacted] $[redacted] during the fourth quarter of [redacted] (the "Intercompany Loan"), which amount remained outstanding through [redacted].

On the Taxpayer's [redacted] consolidated return (the "[redacted] Tax Return") [redacted] reported the Asset Exchange as a like-kind exchange under section 1031, taking the position that on the date of the Asset Exchange the [redacted] Assets and the [redacted] were of equal value. [redacted] nevertheless reported a net gain on the disposition of the [redacted] as a recapture of its overall foreign loss ("OFL") in the general limitation category under section 904(f)(3). Because the [redacted] constituted section 1254 property, part of the gain was recaptured under that section as ordinary income. On the Stock Sale, [redacted] reported a large capital loss. While reporting the Contribution as required by section 6038B, [redacted] claimed that under section 351 no gain or loss was recognized. On the Taxpayer's [redacted] consolidated return (the "1997 Tax Return"), [redacted] reported a deemed repatriation under section 956 equal to the average quarterly balance of the Intercompany Loan.

As foreign corporations, [redacted] and [redacted] were not included in the Taxpayer's consolidated returns for [redacted] and [redacted], but information about their transactions was reported on Forms 5471. On its [redacted] Form 5471, [redacted] reported an accumulated deficit in E&P and a loss on the Asset Exchange.[3] On its [redacted] Form 5471, [redacted]

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to the Internal Revenue Code of 1986, as amended and in effect during the years at issue.

3 On its Form 5471, [redacted] initially reported a substantial

reported a gain on the Cash Sale, the earnings from which supported the section 956 amount included on the [redacted] Tax Return.

To support its valuation of the [redacted] on the [redacted] Tax Return, the Taxpayer relies on [redacted]'s purported offer of $[redacted], notwithstanding that the offer was rejected. Likewise, the Taxpayer relies on that valuation to support its position that the value of the [redacted] did not increase between the date of the Asset Exchange and the date of the Contribution. As re-determined by the Service's engineer, the fair market value of the [redacted] on the date of the Asset Exchange was significantly higher than that of the [redacted] and on the date of the Contribution was higher still. This memorandum considers the federal income tax consequences to [redacted] of these transactions based on the re-determined fair market value of the [redacted].

II. ASSUMPTIONS

The tax advice given herein is based on the facts recited above and the following assumptions:

1. At all times relevant hereto, [redacted] and [redacted] were controlled foreign corporations ("CFCs") within the meaning of section 957.

2. At no time was [redacted] a passive foreign investment company for purposes of section 1291.

3. At no time was [redacted] a foreign personal holding company for purposes of section 552.

4. At no time did [redacted] receive any income or gains from U.S. sources or income effectively connected with the conduct of a trade or business in the United States.

5. [redacted] made no election to recognize exchange gain or loss on capital invested in [redacted]. See Prop. Reg. § 1.367(b)-3(b)(2)(iii).

6. [redacted] had no election in effect under section 1504(d) as to either [redacted].

7. The [redacted] Gas Assets and the [redacted] were Canadian oil and gas properties that were like-kind for purposes of section 1031.

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gain on the Asset Exchange resulting from a lower basis in the [redacted], but upon audit the Taxpayer substantiated the higher basis indicated.

8. The [redacted] lacked the corporate characteristics of centralized management and continuity of life for purposes of section 301.7701-2 of the regulations.[4]

9. The [redacted] did not assume any liabilities or other encumbrances upon the contribution of the [redacted], the [redacted], or otherwise at the time of the formation of the [redacted].

10. On the date of the Asset Exchange, the fair market value of the [redacted] was greater than that of the [redacted].

11. On the date of the Contribution, the fair market value of the [redacted] was equal to that of the [redacted].

12. On the date of the Contribution, the fair market value of the [redacted] was greater than their value on the date of the Asset Exchange.

13. Following the assignment of [redacted]'s interest in the [redacted] to [redacted], (a) [redacted]'s employees continued to provide services to the [redacted]; (b) none of [redacted]'s employees performed managerial services for the [redacted]; and (c) [redacted] did not reimburse [redacted] for salaries paid to the loaned employees or for the value of the services rendered.

14. On date of the Asset Exchange, the basis of the [redacted] in the hands of [redacted] was greater than their fair market value.

15. On the date of the Asset Exchange, [redacted] had no current or accumulated E&P.

16. The election of the [redacted], as defined herein, under section 761 was valid.

III. ISSUE

What are the federal income tax consequences to [redacted] in [redacted] and [redacted] of the Asset Exchange and the Contribution?

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[4] Except as otherwise indicated, all references to regulations refer to the applicable treasury regulations in effect during the years at issue.

IV. AUTHORITIES

A. Tax Consequences of Distribution.

Section 301 determines the tax consequences of a distribution to a shareholder with respect to stock. See I.R.C. § 301. To the extent a distribution constitutes a dividend, it must be included in gross income. See I.R.C. § 301(c)(1). Any amount of the distribution remaining reduces the shareholder's adjusted basis in the stock but not below zero. See I.R.C. § 301(c)(2). Any excess of the non-dividend portion is capital gain. See I.R.C. § 301(c)(3). Under section 301(b), the amount of a distribution of property is equal to the fair market value of the property. See I.R.C. § 301(b). The distributing corporation does not recognize a loss if the property's adjusted basis exceeds its fair market value. See I.R.C. § 311(a).

Section 301 also governs the tax consequences to a shareholder who receives a constructive distribution incident to a bargain sale. See Treas. Reg. § 1.301-1(l). Generally, a bargain sale is a sale or exchange between related parties where the value received by one party, for example, the shareholder, exceeds the value of the consideration given up. To the extent of such excess, the value received is transferred on account of some other relationship or transaction between the buyer and seller. For tax purposes, a bargain sale to a shareholder is bifurcated into two elements: (a) a sale under section 1001 to the extent the values exchanged are equal; and (b) a constructive distribution under section 301 to the extent of the excess value.[5] See Treas. Reg. § 1.301-1(j). Cf. H.R. Rep. No. 1762, 91st Cong., 2d Sess., 1971-1 C.B. 609, 611. The distributing corporation's adjusted basis is allocated proportionately between the sale and distribution elements of the transaction. Honigman v. Commissioner, 466 F.2d 69, 74 (6th Cir. 1972), rev'g and rem'g 55 T.C. 1067 (1971).

B. Like-Kind Exchange

Section 1001 generally determines the amount of gain recognized on a taxable exchange. Under that section, the gain recognized is equal to the excess of the amount realized from the transaction over the taxpayer's adjusted basis. See I.R.C. § 1001(a). The amount realized is equal to the sum of any money received plus the fair market value of the property (other than

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[5] The applicable regulations under section 301 reflect this bifurcated approach. See Treas. Reg. § 1.301-1(j).

money) received. See I.R.C. § 1001(b); Treas. Reg. § 1.1001-2. The taxpayer receives a cost basis. See I.R.C. § 1012.

Where the exchange qualifies as an exchange of like-kind property under section 1031, however, gain or loss is generally not recognized. See I.R.C. § 1031(a). Deferral is appropriate in these circumstances because the taxpayer remains invested in the same kind or class of property; essentially, no cashing-out of the investment has occurred to warrant recognition. See H.R. Rep. No. 101-247, 101st Cong., 1st Sess., 1340 (1989). The taxpayer obtains a substituted basis in the property acquired decreased by the amount of any money received and increased by the amount of gain (or decreased in the amount of loss) recognized. See I.R.C. § 1031(d).

1. **Exception for OFL Recapture.** If a taxpayer sustains an OFL, a portion of the taxpayer's foreign source income in subsequent years will be treated as U.S. source income to the extent of the amount of the OFL. See I.R.C. § 904(f)(1). Section 904(f) thereby reduces the advantage to a taxpayer who had an OFL in a given year that reduced tax on ordinary income and who, in a later year, receives foreign income but would otherwise pay no U.S. tax because of the foreign tax credit. See H.R. Rep. No. 94-658, 94th Cong., 1st Sess., 228 (1975) and S. Rep. No. 94-938, 94th Cong., 2d Sess., 239 (1976). When a taxpayer sustains an OFL in respect of a separate limitation category under section 904, the taxpayer establishes an OFL account for that category, and additions to the OFL account are made to the extent the OFL reduces U.S. source taxable income. See Treas. Reg. § 1.904(f)-1(d). Under section 904(f), subsequently earned foreign source income of the same category as the loss giving rise to the OFL account is re-sourced as U.S. income until the balance in the OFL account is recaptured. See I.R.C. § 904(f)(1); Treas. Reg. § 1.904(f)-2.

For purposes of the foreign tax credit basketing regime, foreign oil and gas extraction income ("FOGEI") is assigned to the general limitation category under section 904(d)(1)(I), although such FOGEI, together with other general limitation income, is subject to a separate section 907 limit. See I.R.C. § 904(d)(1). Generally, FOGEI means the taxable income derived from sources without the United States and its possessions from (a) the extraction of minerals from oil or gas wells, or (b) the sale or exchange of assets used by the taxpayer in that trade or business. See I.R.C. § 907(c). FOGEI also includes dividends from a foreign corporation to the extent such dividends are attributable to FOGEI. See I.R.C. § 907(c)(3)(A).

A disposition of foreign property in a non-recognition transaction triggers recapture of the taxpayer's OFL. Under section 904(f)(3), if a taxpayer disposes of property that has been used predominantly without the U.S. in a trade or business, the taxpayer is generally deemed to have received and recognized foreign source gain equal to the lesser of (i) the difference between the adjusted basis and the property's fair market value and (ii) the remaining OFL. See I.R.C. § 904(f)(3)(A). Under the recapture rule of section 904(f), the foreign source gain recognized is resourced as U.S. income.

Under the OFL recapture rule, a disposition includes a sale, exchange, distribution, or gift of property, whether or not gain is otherwise recognized on the transfer. See I.R.C. § 904(f)(3)(B)(i). The basis of the property received in the exchange is increased by the amount of gain deemed recognized. See Treas. Reg. § 1.904(f)-2(d)(4)(B)(ii). The income recognized solely as a result of section 904(f)(3) is attributed the same characterization it would have had if the taxpayer had sold or exchanged the property in a recognition transaction. See I.R.C. § 904(f)(3)(B)(ii). The amount of the gain subject to recognition and resourcing is determined on an asset by asset basis, that is, gains and losses are not netted. See Treas. Reg. § 1.904(f)-2(d)(4)(B)(flush language). Furthermore, losses from the disposition of an asset in a non-recognition transaction that are not otherwise recognized are not recognized as a result of the application of section 904(f)(3). See id.

2. **Exception for Section 1254 Property.** Section 1254 property includes any property within the meaning of section 614 if intangible drilling and development costs (as described under section 263) are properly chargeable to such property, or the adjusted basis of such property includes adjustments for deductions for depletion under section 611. See I.R.C. § 1254(a)(3). Certain deductions taken with respect to interests in oil, gas, geothermal, and other mineral properties must be recaptured upon a disposition of section 1254 property. I.R.C. § 1254(a). In the case of an otherwise non-taxable, like-kind exchange, the amount recaptured is limited to the sum of the gain recognized on the disposition (without regard to section 1254) plus the fair market value of the otherwise qualifying like-kind property under section 1031 that is not natural resource recapture property. See Treas. Reg. § 1.1254-2(d).

3. **Exception for Related-Party Resales.** A like-kind exchange between related persons is subject to an extended holding period under section 1031(f). For this purpose, a related person means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1). See I.R.C. §

1031(f)(3). If a party disposes of the property received in a related-party exchange within two years, the original exchange becomes taxable to that party. See I.R.C. § 1031(f)(1). By imposing this holding period, Congress sought to prevent basis shifting between related taxpayers and cashing-out contrary to the purpose of section 1031. See H.R. Rep. No. 247, 101st Cong., 1st Sess., 1340 (1989). Any gain or loss recognized by reason of section 1031(f)(1) is taken into account as of the date such later disposition occurs. See I.R.C. § 1031(f)(1). For purposes of the two-year holding period, a voluntary disposition may only be disregarded if the taxpayer establishes to the satisfaction of the Secretary that neither the exchange nor the subsequent disposition had as one of its principal purposes the avoidance of federal income tax. See I.R.C. § 1031(f)(2).

C. Outbound Contribution of Appreciated Property

Ordinarily, a contribution to a controlled corporation is not an occasion for the recognition of gain or loss, but rather is a mere change in the form through which assets are held. See I.R.C. §§ 351(a) and 362(a). In the case of an outbound contribution of appreciated property, however, built-in gain may escape U.S. tax entirely if not taxed at the time of the contribution. To prevent the misuse of section 351 in this situation, section 367(a) generally denies corporate status to the transferee, effectively converting the transaction to a taxable exchange under section 1001. See I.R.C. § 367(a)(1). Specifically, section 367(a)(1) applies to any outbound transfer of appreciated property that would otherwise qualify as a section 351 transaction unless the property falls within an exception, the most notable being that for transfers of foreign business assets (the "FBA Exception"). See I.R.C. § 367(a)(3).

The FBA Exception provides generally that section 367(a)(1) does not apply to property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a foreign trade or business.[6] See I.R.C. § 367(a)(3); Treas. Reg. § 1.367-2T. There are two basic requirements of the FBA Exception: (1) the business assets must be transferred for use in a trade or business outside the United States, see Treas. Reg. § 1.367(a)-2T(a)(1); Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987); Hamrick v. Commissioner, T.C. Memo. 1979-72; Keenan v.

6 In addition, the transferee corporation must have complied with the reporting requirements of section 6038B and the applicable regulations thereunder. See Treas. Reg. § 1.367(a)-2T(a)(2). See also I.R.C. § 6038B; Treas. Reg. § 1.6038B-1T (applicable to transfers occurring prior to July 20, 1998).

Commissioner, T.C. Memo. 1998-388; and (2) the business assets must be actually and directly used in the foreign trade or business of the transferee. Treas. Reg. § 1.367(a)-2T(b)(5). Because of the actual use requirement, the assets cannot be transferred with the intent of disposing of them. See Treas. Reg. §§ 1.367(a)-2T(c)(1) and 1.367(a)-4T(d). A disposition within 6 months of the initial transfer is presumed to violate this requirement. See Treas. Reg. § 1.367(a)-2T(c)(1). After six months, a disposition may violate this requirement depending on whether, in substance, the disposition was part of the same transaction as determined under step-transaction principles. See Treas. Reg. § 1.367(a)-2T(c). In the case of a transfer of a partnership interest subject to section 367, the FBA Exception applies to the underlying property of the partnership, rather than to the partnership interest. See Treas. Reg. § 1.367(a)-1T(c)(3)(ii).

To satisfy the active conduct requirement of the general FBA Exception, officers or employees of the transferee corporation must actually carry out substantial managerial and operational activities with respect to the business assets. See Treas. Reg. § 1.367(a)-2T(b). If employees of a related entity carry on these activities, the active conduct requirement may be met only if the employees are supervised on a day-to-day basis by officers or employees of the transferee corporation *and* if their salaries are paid or reimbursed by the transferee corporation. See Treas. Reg. § 1.367(a)-2T(b)(3). In determining whether the officers or employees of the transferee carry out substantial managerial and operational activities, the activities of independent contractors are disregarded. See id.

An established working interest in oil and gas may qualify for the FBA Exception by meeting special requirements applicable to those interests. See Treas.Reg. § 1.367(a)-4T(e)(1). First, the transferor of the interest must be regularly and substantially engaged in exploration for and extraction of minerals, other than by reason of the transferred interest. See Treas. Reg. §§ 1.367(a)-4T(e)(1)(i) and (e)(2)(i). Second, the terms of the transferred working interest must have been actively negotiated among the joint venturers. Treas. Reg. §§ 1.367(a)-4T(e)(1)(i) and (e)(2)(ii). Third, the transferred working interest must constitute at least a 5 percent interest in the mineral property. See Treas. Reg. §§ 1.367(a)-4T(e)(1)(i) and (e)(2)(iii). Fourth, the transferor must be regularly and actively engaged in either operating the working interest or analyzing technical data relating to the activities of the venture, both before and at the time of the transfer of the working interest. See Treas. Reg. §§ 1.367(a)-4T(e)(1)(i) and (e)(2)(iv). Fifth, the transferor must be regularly and actively involved in making decisions with respect to the operations of the venture both before and at the time of the transfer. See Treas. Reg. §§ 1.367(a)-4T(e)(1)(i) and (e)(2)(v). Sixth, after the transfer and for the foreseeable future, the transferee must be regularly and actively engaged in operating the working interest. See Treas. Reg. §§ 1.367(a)-4T(e)(1)(i) and (2)(vi). Seventh, the transferee must have no intention (determined at the time of the transfer) of disposing of any part of the working interest and, during the three-year period following the initial transfer, must, in fact, not transfer more than 50 percent thereof. See Treas. Reg. § 1.367(a)-4T.

D. Taxation of Joint Operating Agreements

A partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of the Code, a trust, estate, or corporation. See I.R.C. §§ 761(a) and 7701(a)(2). The term partner means a member of a partnership. See I.R.C. 761(b) and 7701(a)(2). A mere expense sharing arrangement is not a partnership because there is no joint profit objective. See Treas. Reg. § 301.7701-3(a). In Bentex Oil Corporation v. Commissioner, 20 T.C. 565 (1953), however, the Tax Court ruled that a typical joint operating agreement for the production of oil and gas where the participants take their respective shares in kind constitutes a partnership for federal income tax purposes. See Rev. Rul. 68-344, 1968-1 C.B. 569. Moreover, the precedents establish that a typical joint operating agreement for the production of oil and gas is something more than expense sharing and should be classified as a partnership absent a predominance of corporate characteristics.

An association is an unincorporated organization having a predominance of corporate characteristics that require classification as a corporation rather than a partnership, estate, or trust. See Treas. Reg. 301.7701-2(a)(1). Six characteristics distinguish corporations from other organizations: (1) associates; (2) an objective to carry on a business for profit and divide the gains therefrom; (3) continuity of life; (4) centralization of management; (5) free transferability of interests; and (6) limited liability. See id. Because associates and an objective to carry on a business and divide the gains therefrom are common to both partnerships and corporations, an unincorporated entity lacking continuity of life and centralized management will be classified as a partnership, rather than as an association. See Treas. Reg. 301.7701-2(a)(3).

Section 761(a) provides for an election out of the partnership rules of Subchapter K by certain qualified partnerships. See Madison Gas & Electric Co., 72 T.C. 521, 563 (1979), aff'd, 633 F.2d 512 (7th Cir. 1980). The election is available to a joint operating agreement among producers of oil and gas to take and separately sell their shares of the oil and gas produced. See Rev. Rul. 68-344, 1968-1 C.B. 569. The Service has consistently treated property owned by an electing partnership as directly owned by the individual partners. See, e.g., Morburger v. United States, 303 F. Supp. 42 (W.D. Ky. 1969)(independent elections for IDC); Rev. Rul. 83-129, 1983-2 C.B. 105 (co-owners of mineral leases held by electing partnership may independently elect to deduct or capitalize their shares of mining development costs under section 616). See also Rev. Rul. 56-500, 1956-2 C.B. 464. Thus, the sale of an interest in an electing partnership should be treated as the sale of a proportionate interest in each partnership asset.

E. Taxation Under Subpart F.

Generally, a U.S. shareholder is not subject to U.S. taxation of the earnings of a foreign corporation until those earnings are distributed. In the case of a CFC, however, the provisions of Subpart F of the Code limit the ability of a U.S. shareholder to defer tax on those earnings. See I.R.C. § 951 et seq. Under Subpart F, a dividend is deemed to the U.S. shareholder to the extent the CFC receives Subpart F income or an investment in U.S. property under section 956. I.R.C. § 951(a).

Subpart F income includes certain types of passive income, including foreign base company income, which, in turn, includes foreign base company oil related income ("FORI"). See I.R.C. § 954(g). FORI is defined as foreign source income arising from the disposition of assets used in a business involving the processing, transportation, or distribution or sale of minerals extracted from oil and gas wells. See I.R.C. §§ 954(g)(1) and 907(c)(2). FORI specifically excludes FOGEI. See I.R.C. §§ 954(g)(1) and 907(c)(1).

An investment in U.S. property means an investment in property located or deemed to be located in the U.S. See I.R.C. § 956(a). Loans made by a CFC to a U.S. shareholder (or other related person) generally constitute investments in U.S. property. See I.R.C. § 956(c). The section 956 amount is determined by averaging the amount so invested as of the end of each quarter of the year. See I.R.C. § 956(a)(1). The amount includible in income equals the excess of that average amount over previously taxed amounts but not exceeding applicable E&P. See id.

A U.S. shareholder taxable on deemed or actual dividends from a CFC may obtain indirect foreign tax credits deemed to have been paid by the shareholder. See I.R.C. §§ 902(a) and 960; Treas. Reg. §§ 1.902-1(b). Generally, a direct credit is available to a taxpayer for foreign income taxes paid or accrued limited to the amount of U.S. tax attributable to the taxpayer's foreign source income. See I.R.C. §§ 901 and 904. A U.S. shareholder receiving an actual or constructive dividend from a CFC is deemed to have paid the same proportion of the foreign taxes as the amount of the dividend bears to the CFC's E&P. See I.R.C. §§ 902 and 960. Thus, the U.S. shareholder receives an indirect credit for foreign taxes paid by the CFC. To determine the source of E&P for this purpose, the separate limitation categories of section 904 apply such that a CFC will have one pool of post-1986 undistributed earnings and one pool of post-1986 foreign income taxes with respect to each separate limitation category of the foreign tax credit. See Notice 88-70, 1988-2 CB 369 (1988). See generally I.R.C. §§ 902, 907, 960, and 964(a); Treas. Reg. § 1.904-5(a)(1). No foreign taxes are deemed paid by a U.S. shareholder if the sum of accumulated and current E&P is zero or less than zero. See Treas. Reg. § 1.902-1(b)(4).

For purposes of determining the foreign tax credit, the benefit of oil and gas extraction taxes is limited by section 907(a). See I.R.C. § 907(a). This section prevents the use of otherwise creditable foreign oil and gas extraction taxes against taxes on income other than FOGEI. Toward that end, the amount of foreign oil and gas extraction taxes creditable under section 901 or 902 is reduced by the excess of the FOGEI multiplied by the highest applicable U.S. tax rate. See I.R.C. § 907(a). The amount of any oil and gas extraction taxes not creditable in the current year by reason of section 907(a) may be carried over to the two preceding and five succeeding taxable years. See I.R.C. § 907(f). If, under limitation rules described in section 907(f)(2), the carried-over taxes do not become not creditable within that period, they expire without tax benefit.

V. DISCUSSION

A. Tax Consequences of the Asset Exchange

As structured by the Taxpayer, [redacted] appears to have paid more than $[redacted] for the [redacted], but in an arms' length transaction a party would not pay more than fair market value. In substance, therefore, the amount of the fair market value of the [redacted] in excess of $[redacted] (the "Excess Value") was not transferred in consideration for the [redacted] but in consideration of [redacted]'s stock ownership, *viz.*, as a distribution with respect to stock under section 301. See I.R.C. § 301; Treas. Reg. § 1.301-1(j). Thus, despite its form as a single transaction, the Asset Exchange in substance constitutes two transactions: an exchange of properties of equal value (the "Equal Exchange") and a constructive distribution to [redacted] under section 301 of the Excess Value (the "Excess Distribution"). See I.R.C. § 301; Treas. Reg. § 1.301-1(j). Both elements of the transaction result in tax consequences to [redacted].

1. **Equal Exchange.** The Equal Exchange portion of the Asset Exchange consists of [redacted]'s exchange of the [redacted] for the first $[redacted] in value of the [redacted]. Assuming the [redacted] and the [redacted] are of like kind, the Equal Exchange initially appears to qualify as a non-taxable, like-kind exchange, subject to the applicable recapture rules. See I.R.C. § 1031(a). Due to the application of the related party resale rule, however, the Equal Exchange is rendered taxable to [redacted] upon the Contribution to [redacted], which violates the two-year holding period. See I.R.C. § 1031(f)(1)(C).

The Contribution is a taxable transaction subject to section 367(a) because the Venture Assets cannot satisfy the FBA Exception. Nor can the Contribution avoid section 367 by qualifying for the FBA Exception. Under the special rules applicable to working interests, the FBA Exception is not satisfied because the Cash Sale violates the three-year holding period. Under the general rules applicable to business assets, the FBA Exception is not satisfied because the active conduct requirement is not met; the [redacted] was not managed by employees of [redacted], and [redacted] did not pay wages, directly or indirectly, for those loaned employees who did.

Under section 904(f)(3), [redacted] must recapture its OFL on the disposition of the [redacted], and the amount of the recapture required should be determined without netting the gains against losses recognized. See I.R.C. § 904(f)(3). The aggregate gain is recharacterized as U.S. income under section 904(f), and the foreign loss is unaffected. Under section 1254, the gain on any section 1254 property is recharacterized as ordinary income to the extent necessary to recapture depletion and IDC expenditures. See I.R.C. § 1254(a)(1).

2. **Excess Distribution.** Section 301 should apply to determine [redacted]'s tax consequences from the Excess Distribution. See I.R.C. § 301(c). Having no current or accumulated E&P out of which to make a dividend, [redacted] could not make a dividend. See I.R.C. §§ 301(c) and 316(a). As loss assets, the [redacted]

would not create any current E&P such as might generate a nimble dividend on their distribution. See I.R.C. § 312(b); Rev. Rul. 74-164, 1974-1 C.B. 74 (situation 2). Under section 301(c), the Excess Distribution reduces [redacted]'s basis in the [redacted] Stock, thereby reducing [redacted]'s loss on the Stock Sale by a commensurate amount. Under section 311(a), [redacted] would not recognize its loss on the distribution of the [redacted].

B. **Tax Consequences of the Contribution**

For U.S. tax purposes, the [redacted] should be treated as a partnership with respect to which an effective election under section 761(a)(2) has been made. See I.R.C. § 761(a)(2). See generally Bentex Oil Corporation v. Commissioner, 20 T.C. 565 (1953). It is clear that the [redacted] was an active business, not merely an expense sharing agreement. See Treas. Reg. § 301.7701-3(a). The [redacted] was not an association because it lacked the corporate characteristics of centralized management and free transferability of interests. See Treas. Reg. 301.7701-2(a)(1). However, because the provisions of Subchapter K do not apply to an electing partnership, [redacted] should be treated as receiving a proportionate share of the Venture Assets in exchange for the [redacted]. See I.R.C. § 761(a)(2). [redacted] should receive a cost basis in its share of the [redacted] equal to the fair market value of the [redacted]. See I.R.C. § 1012.

Thus, the Contribution should be treated as the exchange of [redacted]'s proportionate share of the [redacted] for the stock of [redacted]. See Treas. Reg. § 1.367(a)-1T(c)(3)(ii). As a result of appreciation in value of the Venture Assets between the date of the Asset Exchange and the date of the Contribution, section 367(a) applies to the Contribution, which cannot satisfy the FBA Exception. Under the special rule applicable to working interests, the Cash Sale violates the three-year holding period. See Treas. Reg. § 1.367(a)-4T. Under the general rule, [redacted] cannot satisfy the active conduct requirement. See Treas. Reg. §§ 1.367(a)-2T(c) and (e)(1)(ii) and (iii). Under that rule, the Venture Assets must be operated by [redacted]'s own employees or by those of related parties that are paid, directly or indirectly, by [redacted]. All managerial and other services rendered to the [redacted] were performed by loaned employees of [redacted] and [redacted]. None of [redacted]'s employees performed services for the [redacted], and [redacted] did not reimburse [redacted] for the salaries of its loaned employees. Therefore, the active conduct requirement is not satisfied in these circumstances. The gain is subject to OFL recapture to the extent of [redacted]'s general limitation category OFL. See I.R.C. §§ 904(d)(1)(I) and 904(f)(1); Treas. Reg. § 1.904(f)-2. In addition, the gain should be recaptured as ordinary income to the extent required by section 1254.

C. **Tax Consequences of Cash Sale**

As a U.S. shareholder, [redacted] is not subject to tax on the gain recognized from the Cash Sale to [redacted] unless Subpart F applies to tax [redacted] on those earnings. See generally I.R.C. § 881 and 951 *et seq*. Specifically, section 951 may require [redacted] to include currently in its income its pro rata share of the E&P received by [redacted] from the Cash Sale. Under section 956, the Intercompany Loan would constitute an investment in U.S. property during the last quarter of [redacted]; the quarterly average of [redacted] s investment in U.S. property during [redacted] would therefore equal one-quarter of the amount outstanding at quarter end. See I.R.C. §§ 951(a)(1)(B) and 956(a). The amount so determined under section 956 would result in a Subpart F inclusion to [redacted] to the extent of earnings and profits attributable to non-previously taxed income. See I.R.C. § 959(c).

Less likely is the possibility that [redacted] would have Subpart F income due to FORI. The purpose of the [redacted] was the production of gas from working interests in the [redacted] area. The Venture Assets consisted primarily those working interests or, perhaps more accurately, the right to produce gas from those interests. The gain from the sale of the Venture Assets should therefore constitute FOGEI, not Subpart F income. In addition, however, the Venture Assets included associated downstream refining or transportation assets (not only production and exploration assets), the gain from which may constitute FORI. See I.R.C. §§ 951(a), 952(a)(2), 954(a) and 954(g). Under section 951, the amount of any FORI would be includible in [redacted]'s gross income as a deemed dividend under section 951 to the extent of available E&P. See I.R.C. § 951(a).

By taxing the Contribution in [redacted], as proposed herein, and increasing [redacted]'s basis in the Venture Assets, [redacted]'s E&P in [redacted] should be substantially reduced, limiting the amount of E&P available for taxation under Subpart F. See I.R.C. §§ 1001 and 1012. In addition, the deemed dividend created by section 951 would allow [redacted] to receive an indirect credit under section 902 for foreign taxes paid by [redacted] subject to the limitations of section 907.

VI. CONCLUSION

Based on the fair market value of the [redacted] as re-determined, you should adjust the [redacted] and [redacted] Tax Returns consistent with the foregoing discussion.

[redacted]
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By: [redacted]
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